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No. 94-1340

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

CITIZENS BANK OF MARYLAND,

Petitioner,

vs.

DAVID STRUMPF,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF OF THE NEW YORK CLEARING HOUSE ASSOCIATION, AMERICAN BANKERS ASSOCIATION, INDEPENDENT BANKERS ASSOCIATION OF AMERICA, NATIONSBANK, N.A., NATIONSBANK, N.A. (CAROLINAS), THE FIRST NATIONAL BANK OF MARYLAND, FIRST FIDELITY BANK, N.A. AND CREDIT UNION NATIONAL ASSOCIATION, INC., *AMICI CURIAE*, SUPPORTING REVERSAL

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Question Presented

Does a depository institution violate the Bankruptcy Code's automatic stay under 11 U.S.C. § 362(a) when it imposes an administrative freeze to maintain its right of setoff preserved and recognized under 11 U.S.C. §§ 542(b), 553(a), 506(a), 362(d) and 363(e)?

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This brief is in support of reversal and is filed pursuant to Rule 37.3 with the consent of all parties.

Interest of *Amici Curiae*

The New York Clearing House Association is an association of 11 leading commercial banks in the City of New York; with more than $352 billion in domestic loans outstanding, its member banks are among the nation's largest

consumer and commercial lenders. The American Bankers Association is a trade association for the banking industry, representing banks located in each of the 50 states and the District of Columbia, including national and state-chartered banks of all sizes; the combined assets of its member banks total some 90 percent of all banking assets in the United States. The Independent Bankers Association of America is a nonprofit national trade association that represents the interests of the nation's community banks; its nearly 6,000 national and state-chartered member banks are located in all 50 states and the District of Columbia. Credit Union National Association, Inc. is the national trade association for credit unions, representing the interests of approximately 90 percent of the more than 12,500 federal and state-chartered credit unions operating in the United States with approximately 67,000,000 consumer members. NationsBank, N.A., NationsBank, N.A. (Carolinas), The First National Bank of Maryland and First Fidelity Bank, N.A. also join in this brief.

The issue presented by this case is of the utmost commercial significance to banks and other depository institutions. The Bankruptcy Code[1] makes explicit and detailed provision for preservation of setoff rights, which are fundamental to lending practices and procedures. The rule adopted by the court below, by contrast, would require depository institutions to relinquish their long-established right of setoff in the event of a borrower's bankruptcy, and thus sharply increase the losses that depository institutions suffer as a result of borrower defaults. Depository institutions will be forced to respond by charging higher interest rates, requiring additional collateral or guaranties or, in some cases, refusing to extend credit. Moreover, the rule adopted by the court below injures depository institutions that forbear from

[1] 11 U.S.C. §§ 101 et seq. References to "Section" or "§" are to the Bankruptcy Code (the "Code").

exercising setoff rights prepetition, and will precipitate bankruptcy filings by forcing depository institutions to exercise setoffs at an earlier time. These adverse consequences are unnecessary and will be avoided if courts enforce the Bankruptcy Code as Congress enacted it.

Summary of Argument

In holding that an administrative freeze violates the automatic stay, the Fourth Circuit misconstrued the Bankruptcy Code.

First, the holding below nullifies the protection that the Bankruptcy Code explicitly and comprehensively accords a creditor with a right of setoff. (Point I) Although the *exercise* of the right of setoff is automatically stayed by a bankruptcy filing (11 U.S.C. § 362(a)(7)), the Code authorizes such a creditor to withhold payment of a debt owed the estate to the extent the debt is subject to setoff (11 U.S.C. § 542(b)), preserves the creditor's right of setoff under nonbankruptcy law (11 U.S.C. § 553(a)), provides such a creditor with a secured claim (11 U.S.C. §506(a)), authorizes the creditor to seek relief from the automatic stay (11 U.S.C. § 362(d)), and stipulates that estate property subject to a right of setoff may not be used unless the creditor's right of setoff is adequately protected (11 U.S.C. § 363(e)). The decision below sweeps away these interlocking statutory provisions that carefully accommodate the competing interests of the estate and of a creditor having a right of setoff, by interpreting the automatic stay as prohibiting a depository institution from even placing a hold on a debtor's account to the extent necessary to maintain the status quo with respect to the institution's right of setoff. If a debtor can require a depository institution that is also a creditor to pay an account balance that would otherwise be subject to the institution's right of setoff, the debtor can unilaterally abrogate and nullify the rights afforded by the Code to such a creditor.

Second, the court of appeals erroneously held that an administrative freeze "is tantamount to the exercise of a right of setoff and thus violates the automatic stay of § 362(a)(7)." JA 43a; 37 F.3d at 158. (Point II) In so holding, the court of appeals disregarded widely-accepted prerequisites of a setoff, which a freeze does not satisfy. The court of appeals also failed to reconcile its view concerning § 362(a)(7) with the Code provisions that preserve a creditor's right of setoff, as discussed above. Instead of construing the stay to preserve the status quo, the court of appeals interpreted the stay to enable a debtor to alter the status quo by defeating the setoff rights of a creditor.

Construing the automatic stay as preventing a creditor from maintaining an existing setoff right results in a deprivation of property without due process of law, in violation of the Fifth Amendment to the Constitution of the United States. (Point III) Finally, the result below contradicts the policy objectives as well as the express provisions of the Code. It penalizes a creditor for prepetition forbearance; forces increased bankruptcy filings by encouraging depository institutions to act quickly to exercise setoff rights when borrowers default outside of bankruptcy; and necessitates expensive and unnecessary emergency litigation at the beginning of a bankruptcy case. It will cause increased bank losses and more stringent credit terms. (Point IV)

ARGUMENT

I.

The Bankruptcy Code Authorizes an Administrative Freeze.

The commencement of a bankruptcy case creates an estate. 11 U.S.C. § 541(a). The estate consists of "all legal or equitable interests of the debtor in property as of the

commencement of the case." *Id.* Pursuant to this provision, a debtor's claim against a depository institution for payment of the balance of a deposit account becomes property of the estate. A deposit account represents a debt owed by the depository institution to its depositor, not an interest in cash or a specific fund or other identifiable property of the institution. *Barnhill* v. *Johnson*, 503 U.S. 393, 398 (1992). Through a carefully constructed statutory arrangement, in Section 553 and in several additional sections, the Bankruptcy Code recognizes and preserves the institution's right of setoff against such a debt.

The turnover obligation of an entity (such as a depository institution) that owes a debt that is property of a bankruptcy estate (such as a prepetition deposit account) is governed by Section 542 of the Code ("Turnover of property to the estate"), subsection (b) of which reads:

> "(b) Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under Section 553 of this title against a claim against the debtor.*"

11 U.S.C. § 542(b) (emphasis added). It is thus beyond question that there is no turnover obligation in respect of a debt that can be offset.[2]

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[2] In this case turnover was demanded, not by a trustee, but by a debtor. Section 542(b) authorizes payment of a debt that is property of the bankruptcy estate only to the "trustee," not the debtor. Moreover, pursuant to Section 542(c), if a depository institution, with knowledge of the bankruptcy case, pays an account balance that is property of the estate to a debtor rather than a trustee, the institution is deemed not to have discharged its debt. If we assume, as did the court below, that a

(continued...)

The last clause of Section 542(b) authorizes a depository institution to impose an administrative freeze on a debtor's account by creating an exception to the obligation to pay a debt owed the estate (such as an account balance) to the extent the debt is subject to setoff pursuant to Section 553. *Stephenson* v. *Salisbury* (*In re Corland Corp.*), 967 F.2d 1069, 1077 (5th Cir. 1992) (allowing assertion of a right of setoff as a defense to a turnover action); *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995); *Moreira* v. *Digital Employees Fed. Credit Union* (*In re Moreira*), 173 B.R. 965, 966-67 (Bankr. D. Mass. 1994); *Crispell* v. *Landmark Bank* (*In re Crispell*), 73 B.R. 375, 379 (Bankr. E.D. Mo. 1987). An administrative freeze simply prevents inadvertent payment of an account balance to the extent necessary to maintain the depository institution's right of setoff.

The right to withhold payment of a debt under Section 542(b) is defined with reference to Section 553.[3] Section 553 is directly applicable to a depository institution that owes to a bankruptcy debtor a debt that arose before the bankruptcy case was filed (represented by the debtor's prepetition account balance) and that has a claim (based on a

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[2](...continued)

chapter 13 debtor may exercise a trustee's power under Section 542(b) to demand payment of an account balance that is property of the bankruptcy estate, the limitation that Section 542(b) imposes on the trustee must also apply to the debtor.

[3] Section 553 ("Setoff") provides in pertinent part:

> "(a) Except as otherwise provided . . . in Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ."

11 U.S.C. § 553(a).

loan) against the debtor that arose before commencement of the case. To the extent the depository institution has a right (by contract, statute or common law) to offset these obligations, that right is preserved explicitly by Section 553.

Although a creditor's exercise of its setoff right under Section 553 is subject to the provisions of Sections 362 (the automatic stay) and 363 (use, sale or lease of property of the estate), neither of those sections supports the result below.

Section 362(a) provides that the filing of a bankruptcy petition "operates as a stay" of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7). The purpose of this provision is to maintain — not to alter — the status quo.[4] As discussed in Point II, *infra*, Section 362(a)(7) prohibits only execution of a setoff, not a freeze that prevents nullification of a right of setoff. Section 362 also provides that the court shall grant relief from the stay under specified circumstances on request of a party in interest, 11 U.S.C. § 362(d), and as necessary to prevent irreparable damage to an interest of an entity in property, if such damage will be suffered before the request for relief from the automatic stay can be heard, 11 U.S.C. § 362(f).

Section 363 authorizes a trustee to use property of the estate, including property subject to setoff, in certain circumstances. A trustee may not, however, use property of the estate that is cash collateral (including a deposit account in which an entity other than the estate has an interest,

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[4] "Paragraph (7) stays setoffs of mutual debts and credits between the debtor and creditors. As with all other paragraphs of subsection (a), this paragraph does not affect the right of creditors. It simply stays its enforcement pending an orderly examination of the debtor's and creditors' rights." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 342 (1977); S. Rep. No. 95-989, 95th Cong. 2d Sess. 51 (1978).

11 U.S.C. § 363(a)) unless the entity having an interest in the cash collateral consents or the court, after notice and a hearing, authorizes such use in accordance with the provisions of Section 363. 11 U.S.C. § 363(c); *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994). Any entity having an interest in cash collateral or other property of the estate, moreover, is entitled on request to an order prohibiting or conditioning use of the cash collateral or other property to the extent necessary to provide adequate protection of the entity's interest. 11 U.S.C. § 363(e).

The foregoing provisions contemplate that a depository institution is entitled in the first instance to withhold payment of a debt represented by a debtor's account balance to the extent the balance is subject to a right of setoff. An administrative freeze simply implements the creditor's right under Section 542(b) to withhold payment. It is a procedural action which does not change the substantive rights of the parties. It prevents nullification of the creditor's setoff right preserved under Section 553 and maintains the status quo until the parties agree or a court orders otherwise. The creditor may move for relief from the automatic stay, and if such relief is granted execute the setoff. Assuming a setoff has not been authorized, the trustee (or, in this case, the Chapter 13 debtor) may apply for authorization to use cash collateral (*i.e.*, the account balance subject to the creditor's right of setoff), subject to the creditor's right to adequate protection. *See Bank of America* v. *Edgins* (*In re Edgins*), 36 B.R. 480, 483 (Bankr. 9th Cir. 1984).

Until the court either grants relief from the automatic stay or authorizes the debtor to use cash collateral, the creditor may continue to withhold payment of the amount subject to a right of setoff. Indeed, the Code specifically provides a creditor that has a right of setoff with a secured claim to the extent of such right. 11 U.S.C. § 506(a). In either Chapter 11 or Chapter 13, a plan may not be

confirmed unless the holder of a secured claim retains its lien or its equivalent. 11 U.S.C. §§ 1129(b), 1325(a)(5).

An administrative hold is thus authorized by Section 542(b) and simply maintains the status quo. While it is true that a hold prevents a debtor from obtaining payment of an account balance, a debtor is not entitled under Section 363 to use such balance without obtaining court approval, which at the creditor's request must be conditioned on providing adequate protection.

The court of appeals gave short shrift to the Code provisions that protect a creditor's right of setoff. Section 542(b) is mentioned in a footnote (JA 41a; 37 F.3d at 157 n.*) but is otherwise ignored, even though it should have been dispositive of the issue before the court of appeals. The court of appeals devoted more attention to Section 553(a), but construed Section 362(a)(7) in a way that nullifies the setoff rights that Section 553 explicitly preserves. Similarly, the court of appeals acknowledged that a creditor is entitled to request relief from the automatic stay under Section 362, but nonetheless deemed a refusal to pay an account balance while the request is pending as a violation of the stay. As a result, the creditor would be powerless to prevent a debtor from rendering moot the request for relief from the automatic stay. The court of appeals made no reference to Section 363 or any of its limitations on a trustee's powers or its protection of rights of creditors.

The justification offered by the court of appeals for an interpretation of Section 362(a)(7) that effectively repeals numerous creditor protections explicitly set forth elsewhere in the Code was not based on the words of the statute. Rather it was based on a policy argument, contained in the conclusory assertion that "If a bank could freeze the debtor's accounts upon the filing of a petition in bankruptcy, the debtor's chances for successful rehabilitation would be substantially diminished." JA 45a; 37 F.3d at 159 (*quoting*

United States v. *Norton*, 717 F.2d 767, 773 (3d Cir. 1983)). Even assuming this to be so, the Code does not provide for rehabilitation of a debtor at all costs; rather that goal must be pursued in comity with the rights of creditors. Rights accorded creditors by the Code may not be written out of the Code by a court, even though such rights may hinder or defeat a particular debtor's rehabilitation. *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206-07 (1988); *Air Atlanta, Inc.* v. *National Bank of Georgia*, 81 Bankr. 724 (N.D. Ga. 1987).

Moreover, it is not at all clear why a freeze that protects a right of setoff should prevent successful implementation of a chapter 13 plan, the objective of which is to enable a debtor to pay creditor claims from disposable income during the term of the plan. Such a plan must in any event provide that a secured creditor retains its lien (*i.e.*, in this co ntext, its right of setoff). 11 U.S.C. § 1325(a)(5). The debtor in the meantime can seek relief from the court to obtain access to its deposit account, provided that the depository institution is afforded adequate protection.

In sum, the court of appeals erred by failing to give effect to the limitations on a depository institution's turnover obligation under Section 542(b), the preservation of the institution's right of setoff under Section 553, the institution's right to seek relief from the automatic stay under Section 362(d) (which would be nullified should the institution be required to pay the account balance subject to setoff without being provided with adequate protection), and limitations upon the power of a debtor to use cash collateral under Section 363 (c) and (e) (which require court approval and adequate protection). The Fourth Circuit swept away all the foregoing rights of the institution, and limitations on the powers of the debtor, based on the mistaken conclusion that a freeze in these circumstances is "tantamount to setoff" and is thus stayed by Section 362.

II.

A Freeze Is Not a Setoff and Thus Does Not Violate Section 362(a).

The filing of a bankruptcy petition "operates as a stay, applicable to all entities, of . . . the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 U.S.C. § 362(a)(7).

By its terms, Section 362 (a) provides for a "stay." That is, it operates to maintain the status quo, protecting the estate from dismemberment while the case is being administered.[5] The fundamental error of the court of appeals was to treat the automatic stay as a substantive rather than a procedural provision, to abrogate and defeat a creditor's substantive right of setoff. The court of appeals' decision alters the status quo which Section 362 is designed to preserve by prohibiting the creditor from maintaining it.

A freeze is not a setoff because a freeze does not change the debtor's account balance or loan balance or the parties' obligations. A setoff, by contrast, changes all three. Moreover, a setoff has not occurred unless there has been (1) a decision to effectuate a setoff, (2) an overt act accomplishing the setoff, and (3) a record of the setoff. *See*, *e.g.*, *Horton Dairy, Inc.* v. *United States*, 986 F.2d 286, 291 (8th Cir. 1993). The status quo is altered when a setoff is effected (because the loan and account balance are reduced to the extent they are offsetting) *or* when the account balance subject to a right of setoff is withdrawn by a debtor; a freeze maintains the status quo (*i.e.*, the existing account balance

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[5] The legislative history confirms that the automatic stay does not affect the rights of creditors but simply stays enforcement of such rights. *See* note 4 *supra*.

and loan balance). Therefore an administrative freeze does not satisfy the prerequisites for a setoff. *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995); *Moreira* v. *Digital Employees Fed. Credit Union* (*In re Moreira*), 173 B.R. 965, 967 (Bankr. D. Mass. 1994); *Crispell* v. *Landmark Bank* (*In re Crispell*), 73 B.R. 375, 379 (Bankr. E.D. Mo. 1987).

The court of appeals sought to justify its equation of a freeze with a setoff by observing that "both effectively deprive the debtor of use of the funds." JA 43a; 37 F.3d at 158. In fact, Section 363(c) prohibits the use of cash collateral (such as a deposit account subject to a right of setoff) without court approval or consent of the creditor. An administrative freeze may prevent a debtor from ignoring the requirements of Section 363(c), but a creditor does not violate the automatic stay merely by requiring the debtor to follow procedures that the Code independently requires. Moreover, as set forth above, the creditor's withholding of payment is expressly authorized by Section 542(b). In expanding the meaning of "setoff" to include the mere withholding of payment, the court of appeals erroneously disregarded the established elements of a completed setoff (which the mere withholding of payment does not satisfy), and thereby brought Section 362(a)(7) into conflict with the Code provisions that preserve setoff rights.

The court of appeals did not analyze the relationship between Section 362(a) and the other Code provisions that are relevant to the issue presented, nor did the court of appeals attempt to reconcile its position that a freeze is "tantamount to a setoff" with the material substantive differences between the two. Instead, the court of appeals relied upon three other appellate decisions, *Small Business Admin.* v. *Rinehart*, 887 F.2d 165 (8th Cir. 1989) and *United States* v. *Reynolds*, 764 F.2d 1004 (4th Cir. 1985), both of which in turn rely upon *United States* v. *Norton*, 717 F.2d 767 (3d Cir. 1983). None of those earlier court of appeals decisions reconciles its holding with the Code provisions protecting rights of setoff

or the generally-recognized prerequisites of setoff, and bankruptcy courts in other judicial circuits, recognizing these defects, have refused to follow *Norton* and its progeny. *See, e.g.*, *In re Tillery*, 1995 WL 139231 (Bankr. W.D. Ark. 1995).

In fact, *Norton*, the foundation of these court of appeals decisions, itself rests upon a peculiarity of the law of Pennsylvania and is therefore irrelevant to this and most other cases. *See United States* v. *Norton*, *supra*, 717 F.2d at 772.[6] Even when that peculiar rule is applicable, Section 362(a)(7) prevents occurrence of a setoff by operation of law, so that the creditor may maintain the status quo by withholding payment of an account balance to the extent the creditor has a right of setoff, as provided in Section 542(b). None of the courts of appeals that has addressed this issue has given proper consideration to Section 542(b) or to the peculiarity of Pennsylvania law upon which *Norton* was based.

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[6] *Norton* looked to Pennsylvania law to determine whether a setoff had occurred and concluded that under Pennsylvania law a setoff is accomplished when a creditor gives sufficient evidence of intent to make a setoff, and that the retention of a debtor's funds by a creditor is sufficient evidence of that intent. *United States* v. *Norton*, 717 F.2d at 772. This statement of Pennsylvania law in *Norton* was at variance with the Third Circuit's earlier decision in *Pittsburgh National Bank* v. *United States*, 657 F.2d 36 (3d Cir. 1981), which found that under Pennsylvania law a setoff occurs by operation of law the moment a creditor's claim matures. Had the Third Circuit in *Norton* adhered to *Pittsburgh National Bank*'s reading of Pennsylvania law, it would have concluded that either a setoff occurred by operation of law prior to the bankruptcy filing (in which case the creditor would no longer owe the debt that had been offset) or that the automatic stay prevented a setoff by operation of law post-petition. In neither case was *Norton* justified in equating a withholding of funds with a setoff. *Reinhart*, *Reynolds* and the decision below followed *Norton* even where Pennsylvania law was inapplicable.

The only additional statutory authority cited by any of these decisions is Section 362(a)(3), which provides for a stay of any act "to exercise control over property of the estate." *See Small Business Admin.* v. *Rinehart*, *supra*, 887 F.2d at 168. Clearly, however, this language cannot be read so broadly as to cover a refusal to pay a debt where such refusal is authorized by the Code, and an administrative freeze is nothing more than that. The language of Section 362(a)(3) must be interpreted in harmony with other provisions of the Code, and in particular should not be read to stay conduct that is otherwise authorized by the Code.[7] *In re Lough*, 163 B.R. 586, 588 (Bankr. D. Idaho 1994); *National Bank of Georgia* v. *Air Atlanta* (*In re Air Atlanta, Inc.*), 74 B.R. 426, 427 (Bankr. N.D. Ga.), *aff'd*, 81 B.R. 724 (N.D. Ga. 1987); *Williams* v. *American Bank of the Mid-Cities, N.A.* (*In re Williams*), 61 B.R. 567, 586 (Bankr. N.D. Tex. 1986).

In the case of a deposit account, the estate's property right is a claim against the depository institution; the estate has no property interest in the institution's cash, which is the institution's property. The institution has no control over the estate's claim against the institution, and the refusal to pay the balance (unlike a setoff) does not extinguish or otherwise alter the claim. Nonpayment of a debt that is property of the estate should not be deemed a violation of the automatic stay when nonpayment simply preserves a right of setoff and is thus authorized explicitly by Section 542(b). Indeed, under Section 542(b), a right of setoff is a defense to a demand for turnover. *Stephenson* v. *Salisbury*, *supra*, 967 F.2d at 1077. The assertion of the defense provided by the Code cannot be a violation of the automatic stay.

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[7] Reading Section 362(a)(3) in isolation from other Code provisions leads to results that plainly were not intended. For example, because Section 362(a)(3) applies to all entities, if read in isolation it would prohibit a debtor or trustee, as well as a creditor or other entity, from exercising any control over property of the estate.

The court of appeals erred by applying Section 362(a) not as a stay, but to defeat substantive rights, including rights specifically provided in Sections 553(a) and 542(b). The automatic stay, like the exception under Section 542(b) to the obligation to make payment of a debt owing to the estate, is intended to preserve the status quo. A depository institution's nonpayment of an account balance subject to a right of setoff preserves the status quo until the court authorizes the creditor to effect a setoff, or the debtor to use the account balance after providing adequate protection, or the matter is resolved through a plan or liquidation, in which case the creditor's rights as the holder of a secured claim would be recognized. The result below, by contrast, defeats the status quo and the creditor's right of setoff by permitting a debtor to obtain payment in full of the debtor's account balance.

III.

Construing the Automatic Stay to Prohibit an Administrative Freeze Results in a Deprivation of Property Without Due Process of Law.

A depository institution's right of setoff is not only a contractual right, but also a property interest in the debtor's account balance. The property interest arises from setoff rights that are widely recognized by statute and by common law, and from Section 506(a) of the Bankruptcy Code, providing that a creditor with a right of setoff holds a secured claim to the extent of the setoff right. *See In re Lawndale Steel Co.*, 155 B.R. 990, 992 (Bankr. N.D. Ill. 1993). A secured creditor's interest in a debtor's property is a property interest of which a creditor may not be deprived without due process of law. *United States* v. *Security Industrial Bank*, 459 U.S. 70 (1982). *See* U.S. CONST., amend. V.

The Bankruptcy Code, as any other statute, should be construed so as not to conflict with the Constitution. *Edward J. DeBartolo Corp.* v. *Florida Gulf Coast Bldg. & Constr. Trades Council*, 485 U.S. 568 (1988). Interpretation of the Bankruptcy Code in a manner that nullifies a creditor's right of setoff creates a wholly unnecessary conflict with the Constitution. The constitutional conflict is avoided by giving effect to the explicit protection of creditor interests set forth in Section 542(b) and in the other Code provisions discussed above.

IV.

The Rule Applied by the Court of Appeals Will Have Adverse Consequences for Debtor-Creditor Relations and for the Administration of Bankruptcy Cases.

The rule applied by the court of appeals encourages prepetition setoffs and emergency litigation at the commencement of a bankruptcy case, neither of which is desirable.

A financial institution that has an opportunity to exercise a right of setoff (typically, because a borrower has defaulted under a loan agreement) faces a prepetition choice between action (implementing the setoff) and forbearance. Forbearance provides the best opportunity for rehabilitation. Prepetition setoff encourages bankruptcy. The Code recognizes the desirability of forbearance by preserving the creditor's right of setoff as described above and thereby protecting the creditor after the petition is filed.

The Fourth Circuit's policy choice, that a freeze would diminish a debtor's chances for rehabilitation, 37 F.3d at 159, is at odds with the policy of Section 553 and the other provisions described above and penalizes the creditor for forbearing. Instead of encouraging financial institutions to give

borrowers leeway to straighten out their affairs without having to file under the Code, the decision below discourages forbearance and will result in more bankruptcy filings. As such, the decision is utterly at odds with established bankruptcy policy.

Section 542(b) clearly contemplates that a depository institution with a right of setoff may withhold payment of an account balance to the extent it is subject to setoff. The creditor may then move for relief from the automatic stay if it chooses to do so. The debtor may apply for permission to use cash collateral if it chooses to do so. Or the parties may negotiate a compromise, thus minimizing the need for judicial involvement.

The decision of the court of appeals, by contrast, makes it virtually impossible for a depository institution to preserve a right of setoff. A depository institution could conceivably obtain *ex parte* an order authorizing a freeze pending a hearing on a request for relief from the automatic stay, as suggested by the Fourth Circuit, *see* JA 41a-42a; 37 F.3d at 157-58, but the timing and result are uncertain, and there is nothing in the Code that mandates or encourages *ex parte* litigation to preserve rights the Code already affords. If the debtor demands the account balance before a court order authorizes a freeze, in the court of appeals' view the institution is powerless to preserve its right of setoff. By writing the Section 542(b) exception out of the Code, this result also makes it incumbent upon the depository institution to commence emergency litigation, with attendant expense to the creditor and the debtor and burden upon the bankruptcy court, if the creditor is to have any hope of preserving its setoff right. Such litigation is obviated, without compromising the substantive rights of the debtor or the creditor, if

Section 542(b) and Section 363, along with Section 362, are recognized as controlling.[8]

In sum, the Bankruptcy Code already provides the rules and procedures applicable in these circumstances, and there are good reasons not to substitute the court of appeals' suggested policies and procedures for what the Code requires.

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[8] One court of appeals has held that a depository institution may protect its setoff right when a check is presented for payment of an account balance subject to setoff by filing an *ex parte* motion under Sections 362(f) or 363(e), accompanied by payment of the account balance into the registry of the bankruptcy court, provided it does so by midnight on the next banking day after it receives the check. *B.F. Goodrich Employees Fed. Credit Union* v. *Patterson* (*In re Patterson*), 967 F.2d 505, 511 (11th Cir. 1992). Nothing in the Bankruptcy Code mandates such a cumbersome and expensive procedure — or indeed any procedure — as a prerequisite to the depository institution's exercise of its right to withhold payment of an account balance to the extent of the institution's right of setoff.

Conclusion

For the reasons stated, the decision below should be reversed.

Respectfully submitted,

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